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EAST ASIAN FINANCIAL CRISIS— AN AGENDA FOR ECONOMIC RECOVERY

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**EAST ASIAN FINANCIAL CRISIS —
AN AGENDA FOR ECONOMIC RECOVERY**

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Foreword

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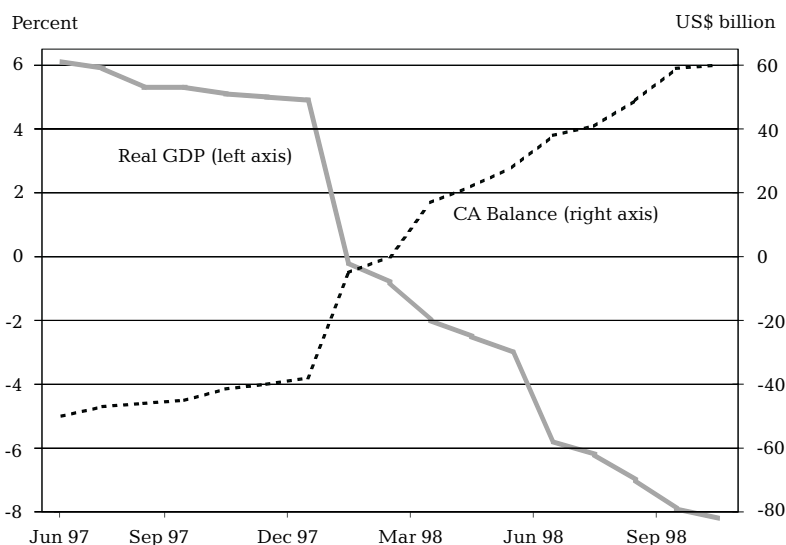
Although the crisis in East Asia is nearly one-and-a-half years old, the economic recession continues to deepen. The social costs in terms of increasing unemployment and poverty levels have been massive. There has been a steady torrent of downward revisions of the region's prospects (Figure 1). For example, earlier last year when the *Asian Development Outlook 1998* (ADB 1998) was being prepared, gross domestic product (GDP) in East Asia was expected to bottom out sometime during the year. Now this is not expected until sometime in 1999. In some countries recovery may even be as far away as 2000. This is in sharp contrast to the Mexican crisis of 1994/1995 when GDP bottomed out after four quarters and recovery began in the fifth.

The picture is more encouraging in currency and stock markets. These markets recovered somewhat in East Asia during the first quarter of 1998—seven or eight months after the crisis—and, despite the ups and downs, they are roughly stable. But even here it is useful to note that the stock and currency markets in Mexico started to recover four to five months after the crisis.

Why has the recovery, both in currency and stock markets and the real economy (including social impacts), been more protracted in East Asia compared with Mexico? One important explanation is the fact that in early 1995, Mexico faced a relatively favorable regional and global environment. The North American Free Trade Agreement (NAFTA) had recently been established and intraregional trade was booming. Also, the United States came up with a large financial package to rescue its next-door neighbor. Similar factors were absent in the East Asian case. The East Asian contagion was more virulent and quickly engulfed the entire region.

Japan was having its own share of economic difficulties including banking difficulties. There was an initial hesitation to address the credit crunch because of the moral hazard problems. But views are changing. Japan's financial sector package, which began in early 1998, and the recently announced largest-ever fiscal stimulus package, should go some way to resolve the banking crisis and bring about economic recovery sometime next year. The benefits should spill over to other countries in the region.

Figure 1. Downward Revision in Consensus Forecasts
(Monthly consensus forecasts for 1998 for GDP growth
and CA balance in East Asia-5)



Note: GDP means gross domestic product and CA means current account in the external accounts. East Asia-5 consists of Indonesia, Malaysia, Korea, Philippines, and Thailand.

Source: Consensus Forecasts, Inc. as published in World Bank (1998b).

The other explanation is that several of the earlier policies failed to address the root causes of the crisis and had perverse impacts. This hypothesis is plausible because although most of the East Asian countries have implemented the policies that they were asked to undertake in the various macroeconomic and structural areas, recovery has been delayed beyond what could be explained simply by the usual slow responses. This is the focus of this paper.

During the 1970s and the 1980s the appropriateness of policies was also questioned. Many argued that the disequilibrium of the balance of payments in the non-oil exporting countries was structural, mainly the result of adverse terms of trade because of oil price increases and not because of expansionary monetary and fiscal policies. There was general recognition that orthodox monetary and fiscal tightening needed to be complemented by structural

reforms (see Rana 1985 for evidence from Asia). In the 1980s, the International Monetary Fund (IMF) introduced the structural adjustment facility and the enhanced structural adjustment facility to deal with these problems.

Mexico 1994/1995 versus East Asia 1997/1998

The Mexican crisis began in December 1994 when the peso was devalued sharply. Similarly, the East Asian crisis began on 2 July 1997 when the Thai baht was floated. It depreciated by 15 percent in the first week. The crisis spread quickly to Indonesia and the Philippines, and by mid-October it moved northeast to the Republic of Korea (Korea). In mid-November, it moved back to Southeast Asia and affected Indonesia with a vengeance. In the first half of 1998, the East Asian contagion spread to Russia and Latin America, and has now engulfed most emerging markets, which together account for roughly one fifth of the world GDP.

The East Asian crisis has exacted a serious toll on the global growth rate. One year ago it was expected that the world economy would grow by 4.5 percent in 1998. This forecast has now been revised downward to 2 percent, which largely because of the crisis, could still turn out to be too optimistic. The revision translates into an output loss of \$600-800 billion, most of it attributable to the East Asian crisis. The US has reduced the federal funds rates preemptively three times last year mainly to avoid the adverse consequences of the East Asian crisis; European countries have followed suit.

Figures 2 to 5 present comparative data on various financial and real sector variables from Mexico during 1994 and 1995 and East Asia from 1997 to 1998. The figures present both precrisis and postcrisis data in index number terms. Although not shown in the figures, it is well-known that initial conditions were more favorable in East Asia than in Mexico in the sense that savings and investments were higher, and resources, including human resources, were more abundant. Also, the magnitude of the shock was relatively less severe in East Asia. For example, Figure 2 shows that by the third month of the crisis, the Mexican stock market (in dollar terms) had plunged by about 70 percent. The figures were lower in the case of

East Asia. Similarly, Figure 3 shows that within the fourth month of the crisis, the Mexican peso had fallen by over 50 percent. Again, in the East Asian case, the corresponding figures were less.

Despite these differences, economic recovery began earlier in Mexico than in East Asia. In Mexico, the stock market began to recover four months after the crisis and five months later it had reached almost 50 percent of its November 1994 level. In the case of the exchange rate, recovery began a month later and since then it has more or less stabilized. By comparison, in the East Asian countries, currencies in four of the five affected countries (except Indonesia), began to recover only seven or eight months after the crisis.

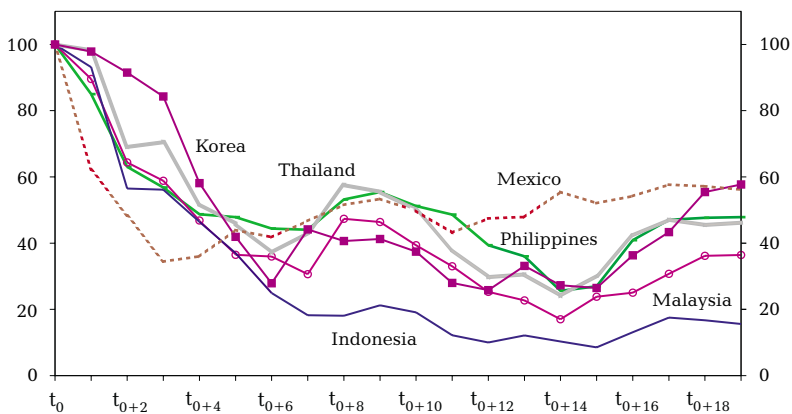
Partly because of the NAFTA agreement, Mexico's exports continued to surge during the crisis period (Figure 4). In the East Asian case, exports have slumped (except in the Philippines) mainly because of the higher cost of capital and imported inputs, the shortage of trade finance (particularly in Indonesia), and the recession in the neighboring countries. Also, while in Mexico foreign capital inflows recovered to their precrisis level six months after the crisis, in East Asia international capital flows have yet to be restored.

Finally, GDP bottomed out in Mexico four quarters after the crisis and started to recover in the fifth (Figure 5). In East Asia, the real sector is not expected to recover until the next year or even the year 2000 for some countries depending on the pace of economic reforms.

The East Asian Crisis and Early Policy Stances

Although the economic situations differed somewhat between countries, initially there were roughly two views on the causes of the East Asian crisis. The first or the standard view argued that the crisis reflected an unsustainable deterioration in the macroeconomic fundamentals of the region. The alternative, or the crisis of confidence view argued that the problems were more self-fulfilling prophecies and financial panic, such as bank runs, fickle investors, and hot money even when the macroeconomic fundamentals appeared to be sound (e.g., Krugman 1998, Radelet and Sachs 1998, World Bank 1998a). A consensus has emerged on the latter view and

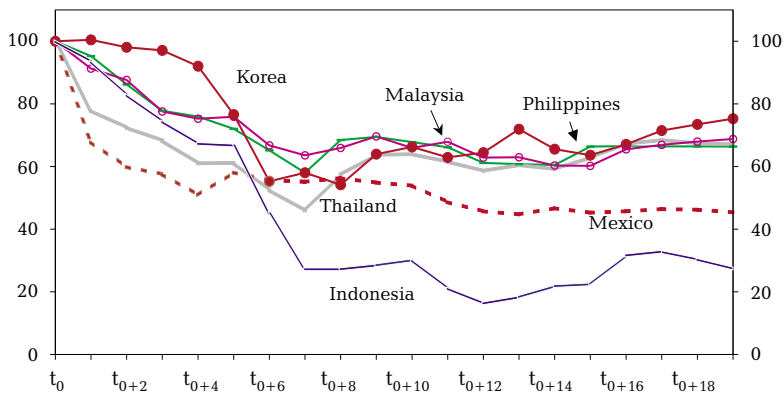
**Figure 2. Mexico 1994/1995 vs. East Asia 1997/1998,
Composite Stock Price Indexes**
(monthly data with $t_0 = 100$)



Note: t_0 is defined as end-June 1997 for the Asian countries and end-November 1994 for Mexico.

Source: Adapted from Bloomberg.

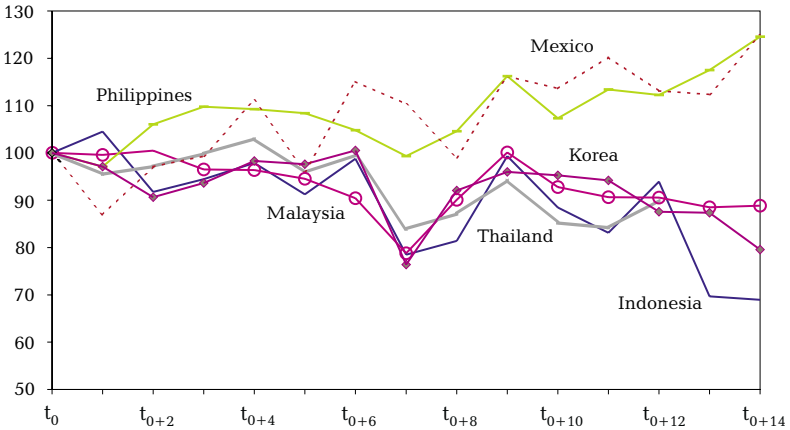
**Figure 3. Mexico 1994/1995 vs. East Asia 1997/1998,
Exchange Rate Indexes**
(monthly data in \$/local currency with $t_0 = 100$)



Note: t_0 is defined as end-June 1997 for the Asian countries and end-November 1994 for Mexico.

Source: Adapted from Bloomberg.

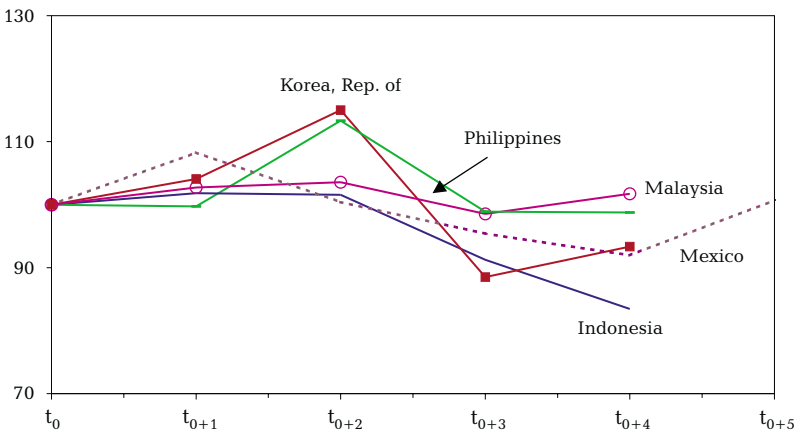
**Figure 4. Mexico 1994/1995 vs. East Asia 1997/1998,
Export Value Indexes**
(monthly data with $t_0 = 100$)



Note: t_0 is defined as end-June 1997 for the Asian countries and end-November 1994 for Mexico.

Source: Various central banks.

**Figure 5. Mexico 1994/1995 vs. East Asia 1997/1998, Indexes
of Gross Domestic Product at Constant Local Currency Prices**
(quarterly data with $t_0 = 100$)



Note: t_0 is defined as the second quarter of 1997 for the Asian countries and third quarter of 1994 for Mexico.

Sources: International Monetary Fund, *International Financial Statistics* (CD-ROM) for Mexico and the Philippines, and country sources for the other Asian economies.

it is agreed that the root causes of the crisis of confidence in East Asia were the structural weaknesses in the financial sector, including lending on a nonmarket basis and policy mistakes in handling large surges of mainly short-term capital flows. The East Asian crisis was not characterized by excessive sovereign borrowing or macroeconomic imbalance. Boorman (1998) of IMF writes "A striking feature of the Asian crisis is that weaknesses in the affected Asian economies—except to a certain extent Thailand—did not arise from the classic macroeconomic problems."

The structural nature of the crisis is by itself enough to explain the protracted nature of the recovery process. The political consensus necessary to implement the reforms is difficult to obtain, especially in the middle of a crisis. Structural reforms involve painful adjustments including mergers and layoffs. Even if implemented expeditiously, they take time to bear fruit, because compared with demand, supply elasticities are generally low.

In addition, however, those who hold the crisis of confidence/structural weaknesses view argue that the early policies have not addressed the root causes of the crisis. Early into the crisis, the affected countries, either under the IMF-led rescue packages (in the cases of Indonesia, Korea, and Thailand) or "virtual" IMF-type policies (in the cases of Malaysia and Philippines until mid-1998), undertook implementation of the standard orthodox monetary and fiscal tightening. Countries were asked to tighten their fiscal stance to preserve budget balance or surplus, and to adopt more restrictive monetary policies to support exchange rates and curb inflation. A comprehensive structural reform package comprising financial and corporate sector reforms, competition and governance policies, trade reforms, and social policies were also implemented.

The macroeconomic components of these policy packages have, however, proved to be controversial. The crisis of confidence/structural weaknesses view argues that high real interest rates and fiscal restrictions, while appropriate in the Mexican case or even during the Latin American debt crisis of the 1980s, were not appropriate in the East Asian case.

While the Latin crisis was largely due to fiscal and current account deficits, in East Asia the situation was very different. Budgets had long been in balance and inflation was relatively low. The

current account deficit in Thailand was close to the Mexican level of 9 percent of GDP but this was not due to fiscal profligacy or monetary expansion. In Thailand, it was the weak regulatory framework of the financial and corporate sector that fuelled large amounts of short-term capital into the system.

Although it now supports the crisis of confidence/structural weaknesses view of the crisis, IMF has rejected criticisms that the deep recessions in the affected countries were due to the fiscal stringency imposed in the initial stages of its bailout programs (IMF 1998). In the immediate aftermath of the crisis there was no alternative to the orthodox policies. It also argues that monetary tightening achieved its objective of avoiding a depreciation and inflation spiral despite some adverse impact on output.

The crisis of confidence/structural weaknesses view, however, challenges this assessment for a number of reasons. First, the East Asian crisis is a crisis of illiquidity more than of insolvency. Creditors "ran" on the currency and on domestic assets, leaving the borrowers unable to continue to finance their loans. Once some creditor banks called in their loans the crisis began to build upon itself as other lenders tried to call in loans and firms cut operating costs and sold assets. This caused unemployment and asset values to fall. The insistence on cutting demand and liquidity accelerated bankruptcy or radical devaluation of the value of firms that were efficient and profitable, as well as those that were not (Radelet and Sachs 1998).

Second, the tight monetary and fiscal policies were also inappropriate for Asian financial structures. Unlike in Latin America or developing regions elsewhere, Asian financial systems are characterized by high ratios of bank deposits and loan intermediation to GDP and of corporate debt to equity. Both of these made their financial structures vulnerable to shocks that depress cash flows or the supply of bank or portfolio capital. The deeper the intermediation of debt (that is, the higher the ratio of bank deposits to GDP, and the higher the ratio of corporate debt to equity) the more likely that any depressive shock will cause illiquidity, default, and bankruptcy (Wade and Veneroso 1998). In East Asia, high real interest rates in countries with high levels of private indebtedness and low inflationary expectations led to corporate bankruptcies and capital outflows

regardless of the attractiveness of high interest rates. They also caused massive contractions in domestic demand. In Indonesia, gross domestic investment in real terms fell by 43 percent in the first quarter of 1998 and by 65 percent in the second. The corresponding figures in Korea were 66 percent and 54 percent respectively (Lee 1998). Growth of private consumption was also weak.

It was, however, not only in the macroeconomic components where the initial policy package was at fault. In the area of financial sector reforms, standard measures of financial restructuring were forced without considering the unique nexus between corporations, banks, and governments in East Asia, and the systemic nature of the banking crisis. Basel rules of 8 percent capital adequacy were applied. Highly indebted banks and firms were closed. Labor laws were made more flexible. Similar measures were applied to resolve the US savings and loan crisis in the late 1980s—and they worked. However, it is one thing to undertake such reforms where real interest rates are very low and indebtedness not high (as in the US), and another to undertake them where both real interest rates and leveraging are high. When the latter conditions prevail, closures and layoffs result, with deflationary repercussions and accelerating capital flight. Closure of bad banks could lead to runs on good banks. As Koo (1998) argues, an appropriate sequencing of reforms when a country is suffering from a systemic banking crisis,¹ is to first fix the credit crunch problem by providing fresh liquidity to banks (through mechanisms such as government-assisted mergers, temporary nationalization, or even, all else failing, bailouts) before restructuring banks. Otherwise it will not be possible to sell the assets taken over from the failed banks back to the private sector because all institutions will be facing capital shortages. What is required is a package of recapitalization measures modeled after the Reconstruction Finance Corporation (RFC) of US President Franklin Roosevelt in the 1930s. In 1933, in the midst of the Great Depression, Roosevelt realized that what US banks needed most was capital, and so he offered to buy the preferred shares of banks through the RFC. This, together with Keynesian-type pump priming, set the stage for the US recovery from the depression, not the

1. Often defined as a situation of negative net worth in the banking system.

market-oriented type restructuring (where compensation to the depositors does not exceed that provided under existing deposit insurance schemes) as in the savings and loan crisis.

Those who held the crisis of confidence/structural weaknesses view also challenge the empirical evidence provided to support the positive impacts of monetary and fiscal tightening. They argue that there is no conclusive evidence that tight monetary and fiscal policies stemmed capital flight and supported exchange rates as is generally claimed. This is either for methodological reasons or the difficulty in establishing counterfactual scenarios of what would have happened without a given policy action. The crisis of confidence/structural view argues that the appropriate policy stance should have been loose money and interest rates. But critics argue that loose money at the early stage after crisis would have depreciated the currency further and increased the foreign currency liabilities of firms and banks. One-and-a-half years after the crisis, however, most observers share the view that the IMF may have been too slow in revising its fiscal targets. It was only after the deep recessions that eventually materialized in 1998 that the IMF progressively loosened fiscal policy. The debate, therefore, goes on.

Notwithstanding the debate, earlier hopes that export-led recovery would begin sometime in the second half of 1998 were not realized. Investor confidence has also not been restored. There is, therefore, a consensus among both groups that the path to economic recovery lies in a more broad-based approach comprising exports and domestic demand. The standard view also supports the move to an expansionary stance because the initial program was successful in restoring the minimum levels of foreign reserves and exchange rate stability through austerity measures.

The affected countries have had modest success in implementing structural reforms—success has been more encouraging in Korea (banking reforms), the Philippines, and Thailand than in other countries (Table 1). However, exports have yet to recover on a sustained basis. On the contrary, the dollar value of East Asian exports, which decelerated sharply in the second half of 1996, continues to stagnate or fall (Figure 4).

It is true that export volumes have increased by double digits in some countries, notably Korea. This is a good sign, but what re-

ally matters are export values, as they determine a country's capacity to import and to service external debt. Volumes have surged in an environment where values are weak because of sharp declines in export prices as exchange rates fell and firms depleted inventory with a fire sale approach. The alternative would be to close down and lay off workers.

In 1996, doubts were expressed about the prospects and sustainability of export growth in these countries. The reasons for the slowdown were a combination of cyclical (mainly the slump in the semiconductor market) and structural factors (including the loss of competitiveness of Malaysia and Thailand in labor-intensive goods). The subsequent reversal of some cyclical factors and the depreciation of currencies were expected to lead to a surge in the value of exports and rescue East Asia. But this has not happened (except in the Philippines); export values have continued to stagnate or tumble.

The tight monetary policies and the restructuring of financial systems in the region have hit exports especially hard. Manufacturers in Indonesia and Thailand, even if they can find a lender, are being squeezed by high interest rates. Local banks in Indonesia are having trouble getting letters of credit honored in overseas markets. Almost all these banks are no longer regarded as creditworthy.

The earlier policy package also had only limited impact on restoring international capital flows to the affected countries. Some encouraging signs of investor confidence emerged in the region during the first four or five months of 1998 following the agreements to roll over and restructure the short-term bank debt of Korea and Indonesia. The stock markets and currencies of the affected countries stabilized and reversed somewhat. In April, the first signs that international capital markets were again accessible to the affected countries appeared. The Philippines launched a \$500 million Yankee bond and Korea followed with a \$4 billion issue, which was three times oversubscribed. Portfolio flows into the Philippines in the first quarter of 1998 were higher than the corresponding figure in the previous year.

Since then, however, resurgence of antimarket sentiments in Hong Kong, China (where the government has been intervening in stock markets), and Malaysia (where, in early September, an alter-

Table 1. Progress in Implementing Reforms in the Affected Countries

| Reform | Indonesia | Korea | Malaysia | Philippines | Thailand |
|---------------------------------------|--|--|---|--|---|
| Banking Reforms | <p>*</p> <p>The country is the slowest in resolving bad loans or attracting investment.</p> | <p>*</p> <p>Headway is being made on bank cleanup, but the private debt bomb remains unresolved.</p> | <p>***</p> <p>The government is recapitalizing banks, but is forcing them to lend more to weak companies.</p> | <p>***</p> <p>Several banks have merged and takeovers of some are expected. Tough regulations of bad loans have been legislated.</p> | <p>***</p> <p>The country is the quickest to sell bad debt.</p> |
| Corporate Sector Reforms | <p>*</p> <p>Corporates are still not solvent. Debtors are only now starting to negotiate workouts.</p> | <p>*</p> <p>The dominance of the chaebols is growing instead of shrinking.</p> | <p>**</p> <p>Bailouts are the preferred solution.</p> | <p>*</p> <p>The credit crunch is slowly easing.</p> | <p>**</p> <p>While some conglomerates are starting to shed assets, the sector is still in dismal shape.</p> |
| Restoring International Capital Flows | <p>*</p> <p>There are big deals in the wake of violence.</p> | <p>**</p> <p>Results are below expectations as chaebols resist selling assets to foreigners.</p> | <p>***</p> <p>Old investors stay put, but capital controls spook new investors.</p> | <p>*</p> <p>Lower than last year, foreign interest on electronics is still strong. Remittances are also strong.</p> | <p>**</p> <p>There are many deals in the finance sector, but little activity in manufacturing and telecommunications.</p> |

*** Very good progress ** Good progress * Poor progress

Source: Adapted from *Business Week* (1998).

native recovery strategy comprising sweeping capital controls and fixed exchange rate was adopted) have, to some extent, scared away foreign investors.

The Path to Recovery and Agenda for the Future

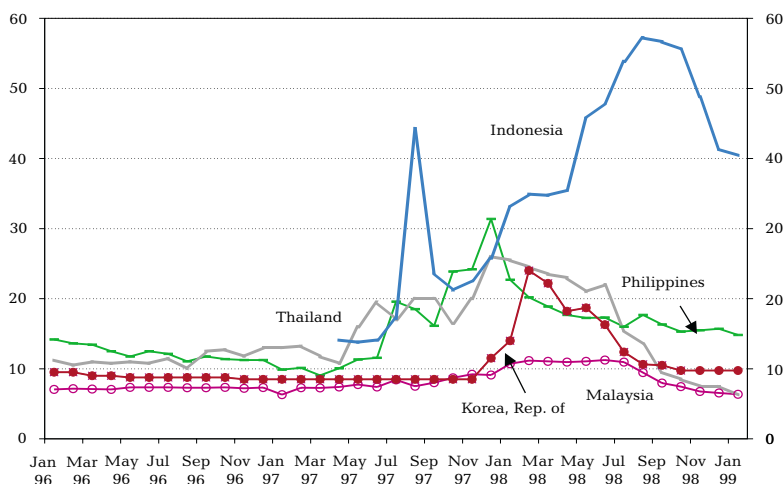
As the effects of the currency depreciation work themselves through and bank restructuring progresses, export performance will surely improve. But it may not be enough to pull East Asia out of the recession. Meanwhile, the sharp currency realignments have worked themselves out through the import channel. By increasing the relative price of imports, they have led to a severe import contraction and improvements in net exports. This, however, is only a second-best approach because import contraction curtails domestic production and demand even further by reducing the supply of imported raw materials and capital goods.

Since export-led recovery is unlikely any time soon, East Asian recovery will have to be more broad-based, comprising expansion of export and domestic demand. The latter will require relaxation of the tight macroeconomic policies in the affected countries.

There is evidence that sometime last year the East Asian countries started gradually switching over to this path, mainly because the standard prescription is not working. As Figure 6 shows short-term interest rates have fallen in the affected countries and are now about the same, if not lower, as the precrisis level in Korea, Malaysia, and Thailand. In the Philippines, rates are about 3 to 4 percentage points higher than the precrisis level. The exception is Indonesia, where short-term interest rates are still very high although they have started to fall since September. Further cuts are required and quite feasible. High interest rates increase the debt-service burdens of corporations and erode their asset and equity values. Since lower interest rates could lead to capital flight, a case can also be made for the use of capital controls on a temporary basis as occurred in Malaysia (Rana 1998). Data in Table 3 also show that in the three countries with ongoing IMF-led rescue programs, greater monetary flexibility has been permitted.

The fiscal position of the three countries with an ongoing IMF-led program became more expansionary in the second half of the

Figure 6. Short-Term Interest Rates in Affected Countries
(percent)



Note: Three-month money market rates.

Source: Adapted from Bloomberg.

year (Table 2). In Figure 6 for example, in Indonesia, the January 1998 letter of intent targeted a fiscal surplus of 1 percent for 1998. The September letter of intent relaxed it to a deficit of 8.5 percent of GDP. Similarly, in Thailand the January letter of intent identified a 1.6 percent fiscal deficit in 1998; this was relaxed to a deficit of 3 percent in August and 6.5 percent in December 1998. Further fiscal expansion is required to stimulate social sector projects to alleviate the social costs of the crisis (ILO 1998). Such expansions are entirely feasible given the low level of deficits in the affected countries. A few principles should be considered by the affected countries when stimulating their economies. First, financing must be through viable borrowing rather than through money creation because the latter will be inflationary and will hurt the poor. Second, since domestic interest rates are high, external financing may be desirable to the extent possible. The Miyazawa package and the recent Asian Growth and Recovery Program are possibilities. Third, levels of fiscal deficits should be tailor-made for specific countries with higher levels in the less indebted countries.

**Table 2. IMF-led Program for Fiscal Balance
and Growth of Broad Money**
(1997 actual and 1998 targets)

| | Indonesia | | | Korea | | | Thailand | | |
|----------------|-----------|------------------|-----------------------------|-------|------------------|------------------|----------|------------------|------------------|
| | 1997 | 1998 | | 1997 | 1998 | | 1997 | 1998 | |
| | | Jan ^a | Sep ^a | | Jan ^a | Sep ^a | | Jan ^a | Aug ^a |
| Fiscal Balance | | | | | | | | | |
| (% of GDP) | -0.9 | 1.0 | -8.5 | 0.03 | -3.6 | -5.0 | -1.4 | -1.6 | -3.0 |
| Broad Money | | | | | | | | | |
| (growth rate) | 23.2 | 16.0 | Flexible ^a -14.2 | 10.2 | 13.9 | | 3.1 | 5.1 | 7.0 |

^aInternational Monetary Fund letters of intent.

^bMonetary policy will be flexible but could be tightened if necessary.

Source: IMF Letters of Intent.

Expansionary policies cannot be effective in the longer term without structural reforms. Despite the commendable efforts in the past year or so, the reform agenda is long and tedious. For example, the affected countries have only made a beginning in reforming their finance sectors. The process will take years. The East Asian countries are facing a systemic banking crisis.²

It is, therefore, first necessary to fix the credit crunch problem before restructuring banks. Some lessons from successful restructuring efforts elsewhere are: (i) adopt a comprehensive strategy, piecemeal efforts do not work; (ii) transfer nonperforming assets to a separate loan recovery agency so that the balance sheet of the bank to be restructured will not be cluttered; (iii) start the process of operational restructuring; (iv) enforce exit policies; and (v) require loan workouts to recover some of the costs.

The social costs of the crisis have been immense. When designing and implementing expansionary policies and structural reforms, the poor must be protected and must share in the fruits of

2. The World Bank (1998a) estimates that in Thailand, 47 percent of the listed companies have balance sheet losses greater than equity, and as a result nonperforming loans of banks range from 20 to 35 percent of the total loan portfolio. The corresponding figures are 78 percent and 50 percent for Indonesia, and 71 percent and 20-35 percent for Korea. In Malaysia and the Philippines, the situation is better, with 21 percent of firms, on average, having losses.

recovery. This requires propoor macroeconomic policies. Fiscal stimulus should also encourage labor-intensive activities such as the development of rural roads and attention to the rural environment. Finally, unemployment benefits or well-targeted public employment programs are essential, as are retraining and job placement programs.

Sometimes, to avoid the risk of destabilizing flows from one country to another and fear of unfavorable investor confidence if only one country were to implement, there may be a case to implement the outlined balanced approach to recovery in a regional context (Bergsten 1998). The World Bank (1998a) has estimated that every one percent of GDP worth of fiscal stimulus throughout the region (including the People's Republic of China and Japan) would boost growth by 2 percentage points in the affected countries.

Summary

Initially, there was a difference of views on the causes of the East Asian financial crisis. Now, however, a consensus has emerged on the crisis of confidence/structural weaknesses view. This view argues that the initial rescue programs, while appropriate for crises that are due to inappropriate macroeconomic fundamentals (e.g., Latin America in the 1980s and the early 1990s), were not appropriate in the East Asian case. Several of the recommended policies, specifically the orthodox demand management policies, were misguided and had perverse impacts. Inappropriate policies have protracted the East Asian crisis. The view goes on to add that a stereotypical one-size-fits-all approach has to be abandoned and that a proper diagnosis is important before a cure can be prescribed.

While subscribing to the crisis confidence/structural weaknesses view of the East Asian crisis, the IMF disagrees with this assessment. It argues that its initial programs have had the intended impacts on currency markets and capital flows. It adds that although monetary tightening has had a cost on the real economy, the alternative would have been worse.

Both camps agree, however, on the need for a more balanced path to recovery comprising both exports and Keynesian-type expansionary macroeconomic policies to boost domestic demand in

the affected countries. While the details of the necessary policy mix will vary across countries, many of the East Asian countries are gradually switching to this path.

In addition to domestic policies, economic recovery in the affected countries depends very much on their external environments. In this context, the recent interest cuts in the US and several European countries together with the largest ever fiscal stimulus and financial revitalization package in Japan are welcome. The reformed policy package together with the improving external environment should pave the way for recovery for many economies in East Asia sometime this year.

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